# Jean-Claude Trichet: Monetary policy in EMU - views and challenges

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Zentrum für Europäische Wirtschaftsforschung (ZEW), Mannheim, 24 June 2005.

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## Introduction

The subject which the organisers have chosen for this conference, namely "Competition in Europe - Europe facing international competition" is not only very topical, but also very challenging. While my presentation today will not focus directly on these issues, I will address them both in my discussion of economic differentials within the euro area and in my concluding remarks.

My main message today is that Economic and Monetary Union (EMU) is beneficial to all of the individual countries which comprise the euro area. I will begin by presenting some key macroeconomic developments which show the great success of the EMU project, not only in terms of price stability and low inflation expectations, but also with respect to the low macroeconomic volatility in the euro area.

I will argue that a high degree of credibility, transparency and predictability on the part of monetary policy are key conditions for this success. Nevertheless, it is not the stability-oriented monetary policy of the ECB alone that has made the success of the euro possible. During the transition to the euro fiscal policies have been more disciplined than before. Moreover, some structural reforms have been implemented and social partners have contributed via wage moderation. One should not overlook these contributions to macroeconomic stability and job creation simply because their positive effects have been diminished by uncertainties and hesitation regarding further reform projects and fiscal policy soundness. Major adverse supply shocks in recent years have also to be taken into account.

Finally, I will discuss the issue of inflation and growth differentials within the euro area. I will explain that these divergences are of a similar size to those observed within the United States. Moreover, inflation differentials are often a normal and welcome equilibrating mechanism within a large currency area. Similarly, persistent real growth differentials may reflect a normal and healthy catching-up process. However, they may also be caused by cross-country differences in economic structures and in the design of economic policies.

## The first years of the euro - price stability and well-anchored inflation expectations …

When taking a closer look at those developments that can be influenced by monetary policy, there can be little doubt that the EMU project has been a great success, which is particularly remarkable against the background of the many and sizeable economic shocks that have hit the euro area since the introduction of the euro.

When looking at the euro area as a whole, a regime shift towards greater monetary stability took place during the second half of the 1990s. This was associated with the EMU project enshrined in the Maastricht Treaty, and in particular with the convergence process and the introduction of the euro.

Since the ECB became responsible for monetary policy in the euro area in 1999, HICP inflation has averaged 2%. This is very near to the "below and close to 2%" at which the ECB aims over the medium term. Let me remind you that during the 1980s and 1990s, the average inflation rate was 4%.

Inflation expectations have also been remarkably stable in recent years. Average long-term consensus inflation expectations have fallen from 2.8% in the 1990s (1990 to 1998) to 1.8% over the past six years. This is fully in line with our definition of price stability.

The very low levels of short-term and long-term interest rates which we are currently observing are providing substantial support to favourable financial conditions. These low levels would be unthinkable without the successful stabilisation of inflation expectations.

## … have also contributed to low macroeconomic volatility

A further remarkable feature of the change in economic performance is the strong decline in nominal macroeconomic volatility. With the convergence process during the 1990s, inflation volatility fell strongly. The volatility of quarterly HICP inflation in the euro area (measured as the standard deviation over the previous six years) fell from around 0.6 percentage point during the late 1980s to less than 0.3 percentage point in the mid-1990s. Since then, inflation volatility has stabilised at this very low level, in spite of major inflationary shocks. And the average volatility of long-term consensus inflation expectations has also declined substantially, by four-fifths, from almost 0.5 percentage point in the 1990s to around 0.1 percentage point in recent years.

Lower volatility of actual and expected inflation reduces consumer and investor uncertainty and thereby enhances welfare. Stable inflation expectations and a high degree of confidence on the part of financial market participants in monetary policy should, over time, also lead to a reduction in the volatility of longer-term interest rates, and thus also to lower risk premia. Indeed, over the past six years, there has been a substantial decline in the volatility of long-term interest rates as compared with that recorded in the past decade. In the 1990s, for example, the standard deviation of long-term interest rates (monthly data) was around 2 percentage points; in the past six years, this measure has fallen to a little more than ½ a percentage point. It is striking that, while the volatility of long-term interest rates in the euro area was still around twice as high as that in the United States in the 1990s, the situation has reversed in the last six years, with euro area interest rate volatility now being below that observed in the United States.

Anchoring inflation expectations is not only important for low medium- and long-term market interest rates. It is also crucial for reducing macroeconomic fluctuations in response to economic shocks. There are some hints that the persistence of inflation in recent years has been lower than before. It is likely that this has resulted, at least partly, from the improved anchoring of inflation expectations which may, in turn, have led to a more forward-looking behaviour on the part of those setting prices and wages. Less indexation of wages and prices to current and past inflation would tend to contribute to lower volatility of employment and output in response to macroeconomic shocks.

Importantly, the achievements in the area of monetary stability have not come at the cost of higher unemployment. On the contrary, the unemployment rate has averaged around 8½% over the past six years and has therefore been more than one percentage point lower, on average, than in the 1990s. Annual employment growth (in terms of persons employed) has doubled from an average of around ½% in the 1980s and 1990s to slightly above 1% since the start of the single monetary policy. Average real GDP growth has been 1.9% in the past six years, which is close to the average of 2.0% in the 1990s (1990-1998).

Moreover, there are no visible signs of costs in terms of higher real macroeconomic volatility; on the contrary, in recent years the volatility of some real variables has also declined relative to the averages observed during the 1980s and 1990s. For example, the standard deviation of quarter-on-quarter percentage changes of real GDP growth has fallen from around 0.5 percentage point in the 1990s to around 0.4 percentage point in the last six years. The volatility of employment growth has also fallen from over 0.3 percentage point to 0.2 percentage point.

All in all, however, some encouraging structural reforms notwithstanding, the high degree of monetary stability achieved stands in contrast to the as yet insufficient flexibility and dynamism of some euro area economies. The latter phenomenon explains why the success of EMU has not been accompanied by higher real growth. In particular labour productivity growth has been weak since the mid-1990s, and unemployment in many euro area countries is still far too high. These problems need to be addressed by stepping up structural reforms. An inflationary monetary policy would certainly not be of help - on the contrary, it would make things worse.

**The preconditions for credibility and anchoring of inflation expectations**

Let me now turn to the question of why we have been able to stabilise inflation expectations, and thus interest rates, at low levels. I discussed the convergence of long-term interest rates to very low levels in the late 1990s in a recent presentation[1], in which I attributed this success to a shift to a more credible policy regime. Several institutional provisions enshrined in the Treaty as well as strategic

[1] See J.-C. Trichet, " Monetary Policy and Private Expectations", Zolotas Lecture at the Bank of Greece, Athens, 25 February 2005.

decisions of the Governing Council of the ECB have been necessary preconditions for a credible monetary policy and a successful anchoring of inflation expectations.

With regard to the key institutional provisions, the ECB has been given a clear mandate, namely to pursue the primary objective of maintaining price stability, and its independence is fully guaranteed by the Treaty. Furthermore, rules for pursuing sound fiscal policies are enshrined in the Treaty in the form of the Maastricht criteria; the Stability and Growth Pact implements these principles via regulations.

As regards the key strategic decisions, the Governing Council of the ECB has designed a stability-oriented monetary policy strategy. This monetary policy concept is based on an arithmetic definition of price stability and on a two-pillar approach involving not only an economic pillar, but also a monetary pillar. Our commitment to monitoring monetary developments provides powerful support to anchoring long-term inflation expectations. The precise definition of price stability for the euro area showed full continuity with the national central banks' earlier core definitions of price stability and thus ensured that inflation expectations for the new currency would be the same as for the most credible national currencies immediately before the setting up of the euro.

Finally, the ECB has opted for a high degree of transparency. From the very beginning, key features of the monetary policy strategy have been published. Moreover, almost in real time, the monthly assessment of the Governing Council and the reasons for the interest rate decisions taken are presented to the public at the press conferences immediately following the first Governing Council meeting of each month.

All of these factors have contributed to the high degree of credibility enjoyed by the ECB's monetary policy and thus to price stability and the successful anchoring of inflation expectations. But credibility is never gained once and for all. It has to be permanently preserved and enhanced. That is why, for central bankers, vigilance is always of the essence and why the ECB pays the utmost attention to monitoring inflation expectations.

### Inflation and growth differentials among countries in the euro area are moderate …

In recent months there has been a renewed interest in the issue of economic differentials between euro area countries. Regional differentials in growth and inflation are a standard feature of all large currency areas around the world. In the euro area these differentials are of a similar size to those observed within the United States. Let me provide some figures.

The degree of inflation dispersion across the euro area countries was characterised by a strong downward trend in the 1980s and 1990s and has broadly stabilised since the inception of the euro. Inflation dispersion among the euro area countries (measured as the unweighted standard deviation of annual HICP inflation rates) was around 6 percentage points in late 1990, while it amounted to slightly less than 1 percentage point in spring 2005. The average inflation dispersion across the euro area countries has been 1 percentage point since the launch of the euro. This figure is very close to the dispersion observed across the 14 US metropolitan statistical areas.

The dispersion of real GDP growth rates in the euro area has, since 1999, remained very close to its historic average, without any signs of increased divergence having emerged so far. In the period from 1999 to 2004, the average dispersion of annual real GDP growth (measured as the unweighted standard deviation) was around 2 percentage points, and thus very close to the average dispersion of real growth rates since the 1980s. By comparison, the dispersion of real growth across the US States fluctuated around an average of 2½ percentage points between 1990 and 2002, while the average dispersion of the real growth rates was around 1½ percentage points across the eight US statistical regions.

### … and may reflect welcome adjustment processes

In a monetary union, inflation and labour cost differentials across regions or countries are the natural means of adjusting relative prices in the face of asymmetric demand or supply developments.

The fact that the single monetary policy cannot address specific circumstances in individual countries implies that flexible wages and prices are needed in order to deal with regional shocks or disparities in relative demand across regions. For example, regions facing a shortfall in demand relative to potential supply or a loss in cost competitiveness need to exhibit lower prices and costs for domestically produced services and goods. If wages and prices are flexible and respond quickly, this will support employment and purchasing power and thus contribute to closing the demand shortfall. In addition, price and wage changes below the euro area average imply that the competitiveness of the country would increase vis-à-vis the other regions and, as a result, that external demand would also contribute to closing the gap between actual and potential output. If labour and product markets are rigid, however, the shortfall in demand will not lead to a swift and adequate decline in relative wages and prices, unemployment in the region will increase and the related regional disparities could persist for some time.

In this context, I should like to make three remarks concerning the euro area.

First, changes in relative prices within the single currency area have been larger and more frequent than anticipated. The idea that the euro area is an area in which the single currency prevents adjustment of relative prices has been clearly refuted. For instance, the capacity of the German economy to catch up rapidly with the average of the euro area in terms of cost competitiveness after the loss of competitiveness associated with German reunification has been very impressive. Strong increases in relative unit labour costs during the first half of the 1990s contributed, with some lag, to higher unemployment. For example, between 1992 and 1998, unemployment in Germany increased by almost 2½ percentage points. In recent years, however, increases in unit labour costs have been very moderate, so that the conditions for job creation have clearly improved. This development also shows that wages and prices are more flexible than sometimes thought. From that point of view, the euro area is more flexible and adaptable than was anticipated by a number of observers.

Second, the aforementioned process is symmetric. In some cases the existence of positive inflation differentials is the natural consequence for an economy that has been outperforming the average in terms of cost competitiveness and reached rather low levels of unemployment. For such economies inflation above the euro area average may be the natural way to adust towards a more normal price level in line with the average. This problem had been observed, for instance, in the case of the Netherlands and is possibly still relevant for Ireland.

Third, inflation differentials are not only the necessary means of achieving relative price adjustments within the euro area, as in the case of Germany, they are also a natural feature of some economies in the euro area in view of their gradual convergence and catching-up process with regard to the average European GDP per capita. Real growth differentials may be welcome if they reflect such a healthy catching-up process on the part of less advanced economies. Indeed, since the mid-1990s, most of the countries which previously had GDP per capita levels significantly below the euro area average have experienced above-average real GDP growth rates. This is particularly true for Ireland, Spain and Greece. A healthy catching-up process is not a zero sum game, it is a win-win situation, as those countries which are already more productive can benefit from increased trade and investment opportunities. Crucially, EMU increases the chances of achieving such a welcome outcome.

A credible monetary policy anchors inflation expectations and increases market transparency, thereby facilitating the necessary adjustment of relative prices across different countries or sectors in the presence of economic shocks. In addition to the positive effects of monetary stability, a single currency enhances the processes of financial and trade integration within the euro area. And we have also observed increased risk-sharing between euro area countries. Thus, the euro and the single monetary policy contribute not only to the competitiveness of the euro area and to job creation, but also to real convergence.

### Cross-country differences may also signal the need for changes in national economic policies

I have just given three economic reasons why cross-country differentials in price and labour cost changes reflect welcome adjustments in relative prices within a single currency area. However, there is one case in which such differentials are not advisable in terms of national economic policies: this is when an economy with an already relatively low level of cost competitiveness and high unemployment faces further deterioration on account of higher price and cost inflation. In that case, additional attention must be given to increasing the flexibility and adaptability of the institutions and market structures in the national economy concerned in order to allow the appropriate adjustment mechanism to function, and to redress the relative deterioration of cost competitiveness.

There are cases where lasting real growth differentials do not reflect welcome catching-up processes, but rather structural deficiencies in some countries, leading to low trend output growth and persistently high unemployment rates. Such divergences between different countries are independent of whether or not these countries share the same currency, and in any case cannot be addressed by monetary policy. Countries that show a relatively poor performance in terms of longer-term trends of real growth and job creation are often also those whose domestic economy has been less flexible. For these countries structural reforms are highly advisable.

Measures aimed at strengthening product market competition, labour market flexibility and thus job creation would certainly be welcome. They would enhance the incentives for firms to both invest in real and human capital and offer new jobs. Close monitoring of unit labour cost and wage moderation are also, in such cases, essential to reduce excessively high unemployment.

The more successful the structural measures are, the more jobs will be created at current wage levels and the less wage moderation will thus be needed in the long run. However, for those sectors and areas of qualification in which unemployment is high and/or the competitiveness of domestic workers is threatened, wage moderation, will be important to support job creation, and thus consumption demand. Let me stress that both types of measure - reforms and wage moderation - support employment even in a rather closed economy. Of course, both measures would tend also to enhance external competitiveness, but their positive effects do not depend on this latter channel.

Sometimes a radically different equilibrating mechanism is suggested. It has been argued that a euro area country that experiences relatively weak aggregate demand should increase wages more strongly in order to ensure higher demand for domestic goods. This would, however, be counterproductive. Higher real wage and unit labour costs in areas where unemployment is too high would undermine job creation and thus reduce demand and supply even further. Of course, once full employment has been reached, real wages can and should grow in line with productivity increases.

## All countries and economies benefit substantially from EMU

As I am speaking here in Mannheim, let me emphasise that the economies that had a very credible currency before the euro such as Germany are benefiting substantially from their integration into the euro area. The euro is as credible and stable as the Deutsche Mark before it. The purchasing power of German workers and consumers has been enhanced by relatively cheap imports from countries within Europe and beyond. Employment has been supported by strong export growth, not least to euro area and EU trading partners. Market interest rates and thus financing costs have not only been maintained at the previous low levels but they are at historically very low levels. The fact that in some economies inflation has been somewhat lower than the euro area average for some time should not be seen as a disadvantage. It supports the purchasing power of consumers, and it is a reflection of the increasing cost competitiveness of the production of these economies. The success of German exports offers a good illustration of that phenomenon. Some observers have argued that traditionally low interest rate economies are suffering as a result of EMU, as their interest rate comparative advantage relative to other countries was removed with the convergence process and the introduction of the euro. However, the fact that all euro area countries now enjoy stable prices, low inflation expectations and thus low financing costs is also beneficial for economies such as Germany, not least by enhancing trade and financial integration. On top of that the elimination of any exchange risk within the euro area is also beneficial for all euro area countries including for the traditionally low interest rate economies which have in the past suffered a lot from the materialisation of such risks.

## Conclusion

Let me conclude my presentation by coming back to the subject of this conference. I have explained today how EMU and a credible monetary policy benefit all euro area countries and create great opportunities for a dynamic economy and job creation. A good monetary policy is necessary and can achieve a lot - but cannot, alone, guarantee full success. Other conditions are also necessary. One cannot stress enough that a high degree of competition and a functioning market economy are crucial preconditions for job creation, high real wages and, more generally, high living standards.

Laws or institutions that hinder competition between existing firms and the entry of new competitors and thus the effective working of market mechanisms tend to support excess prices, incomes and profits in those sectors that are protected. Of course, the costs of such protection have to be borne by consumers in the form of overly high prices and by the unemployed in the form of fewer opportunities for new jobs. However, it is not only the competitiveness of firms that is of great importance in our economies. In addition, we need to enhance the functioning of labour markets and to provide incentives for investing in human capital in order to ensure the “competitiveness of labour”.

A single currency and identical policy rates across the euro area in a certain sense also enhance the possibility to better compare economic performances between Member States and to draw lessons from national experiences in terms of economic structures and policies. A single monetary policy implies that lasting divergences in unemployment levels and real growth trends are caused predominantly by different economic structures and economic policies in individual countries. Moreover, income levels can more easily be compared across countries which use the same currency. Monetary Union thus makes it easier for citizens to identify best practices in other countries. This benchmarking benefits all the citizens of the euro area - in much the same way as consumers benefit from increased competition between firms in the form of higher quality and/or less expensive products. Good and promising practices or policies can be better identified and more widely implemented, while less successful or ill-designed economic policies are easier to recognise.

I am fully aware that it is not easy to implement structural reforms and consolidate government budgets because of the fact that the public opinion is sometimes not fully convinced that everybody would benefit from these reforms. The ECB, for its part, is not lecturing anybody, but considers itself part of the necessary process of awareness raising, of tireless explanation. We all need to explain to the citizens of Europe that policies which enhance competition, competitiveness and flexibility contribute to higher employment and will ultimately improve prospects for real wage developments, growth and consolidation of government budgets.